Chapter 33

The Basics of Risk Management

After completing this chapter, you will be able to:

Section 33.1 Types of Risk
- Discuss risk and risk management.
- Describe different types of risk.

Section 33.2 Handling Risk
- Describe four ways that individuals and businesses can handle risk.
- List types of insurance protection.

Ask

STANDARD &POOR’S

The Basics of Risk Management: Credit Risk Assessment

Q: How does a bank assess its risk when making a large loan to a company?
A: Credit risk is the possibility that a company may not make timely payments on its outstanding debt. In the worst cases, the company never pays back what it owes. Banks must assess a company’s credit risk before they decide whether to grant a loan to the company. Using various credit risk assessment templates, banks determine the credit scores, the probabilities of default, and rating estimates of the company. Based on this information, they may grant the loan or decide not to if the risk is too great.

Mathematics Danielle has $1,800 in credit card debt and still owes $6,200 on her car. Her annual income is $32,000. She has requested a credit line from the bank. Before granting her the credit, the bank must calculate her debt-to-income ratio. If the bank’s cutoff for granting credit is 0.35, will she be eligible?

CONCEPT Calculating Ratios A ratio is a comparison of two numbers using division. Ratios are usually written in simplest form, so the ratio “8 out of 10” is written 4 to 5, 4:5, or \( \frac{4}{5} \). Sometimes a ratio is represented as one number as either a percent or a decimal.
Managing Risk  Businesses face many different types of risk. Why do you think it is important for people to know what risks a business might face?
Section 33.1

Types of Risk

Reading Guide

Before You Read

Think about the various types of risk that you face in your daily life.

Read to Learn

• Discuss risk and risk management.
• Describe different types of risk.

The Main Idea

Everybody faces risk that can lead to loss, injury, or even death. Individuals and businesses can use strategies to manage risk as ways to reduce or avoid loss.

Key Concepts

• Risk Management
• Types of Risk

Vocabulary

Key Terms

risk
risk management
insurable risk
insurance
uninsurable risk
controllable risk
uncontrollable risk
pure risk
economic risk
human risk
natural risk

Academic Vocabulary

You will find these words in your reading and on your tests. Make sure you know their meanings.

criteria
minimize
decade
occurrences

Graphic Organizer

In a figure like the one below, give examples of each of the four types of risk.

<table>
<thead>
<tr>
<th>Types of Risk</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurable</td>
<td></td>
</tr>
<tr>
<td>Uninsurable</td>
<td></td>
</tr>
<tr>
<td>Controllable</td>
<td></td>
</tr>
<tr>
<td>Uncontrollable</td>
<td></td>
</tr>
</tbody>
</table>

Go to the Introduction to Business Online Learning Center through glencoe.com for a printable graphic organizer.

Academic Standards

English Language Arts

NCTE 1 Read texts to acquire new information

Mathematics

Algebra Use mathematical models to represent and understand quantitative relationships
Risk Management

All people and businesses make decisions that create risk. A **risk** is the possibility of loss or injury. You face risk daily. Some types of risk may be easier for you to tolerate than others. For example, if you ride in a car, bus, train, or plane, you take the risk of having an accident. You can also fall down the stairs at home or at school. **Business risk** is risk that businesses specifically face, such as the potential for financial loss. You cannot eliminate all risk, but you can reduce and manage it. **Risk management** is the systemic process of managing risk to achieve your objectives.

Types of Risk

There are several different types of risk. Risk may be insurable or uninsurable, as well as controllable or uncontrollable. Risk can be further identified as pure, economic, human, or natural risk.

An **insurable risk** is a risk that meets an insurance company’s criteria for insurance coverage. **Insurance** is paid protection against loss due to injury or property damage. Drivers who have vehicle insurance present insurable risk. **Uninsurable risk** is a risk that is unacceptable to insurance carriers because the likelihood of loss is too high. A store owner might have difficulty finding insurance for a shop that is located in a flood zone.

![Figure 33.1 - Planning to Manage Risk](image)

**Are You Prepared?** Being prepared to face risk is an important way for businesses to manage the possible consequences. Which step do you think is most important?
**Controllable risk** occurs when conditions can be controlled to minimize the chance of harm. Environmental damage is a controllable risk that, in many cases, can be prevented. An **uncontrollable risk** cannot be controlled. For example, risk involved in doing business in the global marketplace cannot be controlled.

**Pure Risk**

A **pure risk** is the threat of a loss with no opportunity for gain. If you drive a car, for example, you run the risk of being in an accident and suffering loss and/or injury. Your insurance company will not issue you funds for avoiding an accident. Therefore, if you avoid an accident, you do not have an opportunity for gain. Of course, you would still try to drive carefully and avoid accidents. Businesses run the risk of loss from employee theft, burglary, bad checks, and accidents involving customers and employees. Businesses do not receive insurance funds for avoiding financial losses due to these occurrences. The purpose of insurance is to hedge against the risk of potential financial loss.

**Economic Risk**

**Economic risk** occurs when there is likelihood of economic loss. Even if you are very careful, you will not be able to avoid all risk. You can, however, protect yourself against economic loss. For businesses, economic risk results from changes in overall business conditions. If businesses fail to change their products when competitors offer more features, they may lose sales and face economic harm.

Economic risk can be related to property and to your own personal well-being. It can be placed in three categories: personal risk, property risk, and liability risk. **Personal risk** is risk associated with illness, disability, loss of income, unemployment, aging, and premature death. **Property risk** is the risk of damage to or loss of property due to theft, wind, fire, flood, or some other hazard. **Liability risk** is the potential for losses to others that occur as a result of injury or damage that you may have caused.

**Human Risk**

**Human risk** is the risk of harm caused by human mistakes, dishonesty, or another risk that is attributed to people. Risk may be caused by people who are careless or dishonest. A friend might...
borrow something from you and damage or lose it. You might lose money to someone who snatches your wallet or purse. For businesses, human risk ranges from the financial impact of theft or embezzlement to job-related injury or illness.

**Customer Dishonesty** Human risk can be caused by customer theft, fraudulent payment, or nonpayment. Losses due to shoplifting are passed on to consumers through higher prices. Price increases are needed to pay for inventory shortages, security personnel, and the installation of theft prevention systems. Other examples of customer dishonesty include nonpayment of accounts or the use of stolen checks or credit cards.

**Employee Risk** Employees represent another human risk to businesses. Employees may cause loss. Companies depend on employees to do their job well. For example, commercial airlines prepare crews for emergencies caused not only by mechanical problems but also by human factors. If a flight attendant fails to keep an aisle clear, a passenger could trip and fall, break an arm, and sue the airline. Accidents like these can be financially devastating to a small business. The possibility of employee theft poses another risk to businesses.

**Computer-Related Crime** Over the past decade, computer-related crime has emerged as a significant new human risk to business. Malicious programs called computer worms or viruses can be inadvertently downloaded by employees and can wreak havoc on internal computer networks and communication systems. Hackers may break into computer systems to gain access or information for mischievous or criminal purposes.

**Natural Disasters** Damage from a tornado can be devastating. **What type of risk does a tornado represent?**
Computer crime is committed by many different kinds of people—from current or past employees to professional cyber thieves. Businesses can reduce computer crime by keeping computer networks secure and using passwords, encoded firewall programs, and virus detectors. Employees can be trained on privacy policies and proper handling of confidential information.

**Crime Prevention** People try to avoid risks associated with crime by taking precautions at home and in public. To protect against theft, many businesses install closed-circuit TV systems and point-of-service terminals that generate reports. They also thoroughly review job applicants. To protect against losses due to bad checks and credit cards, they use check-reader and credit-authorizer machines. Companies hire security guards and install high-quality locks, proper lighting, and alarm systems.

**Natural Risk**

A natural risk is the possibility of a catastrophe caused by a flood, tornado, hurricane, fire, lightning, drought, or earthquake. These natural occurrences can cause damage or loss of property. Some risk is caused by people and is also called natural risk. Power outages, oil spills, arson, terrorism, and even war are classified as natural risk.

---

**Section 33.1**

**Review Key Concepts**

1. Why do businesses and individuals practice risk management?
2. What are the four main types of risk discussed in the chapter?
3. Describe some types of human risk.

**Academic Skills**

4. **Mathematics** Your auto insurance policy has a bodily injury ratio of 1:4. This ratio describes the relationship between the maximum coverage for individual bodily injury and all bodily injury. If the most the policy pays for individual bodily injury is $150,000, what is the most it will pay for all bodily injury?

   **CONCEPT** **Ratios** A ratio is a comparison of two quantities. A ratio of 1:2 means one part of the first quantity to two parts of the other. If the first quantity is 10, find the second quantity by multiplying by 2 to get 20.

   **Math** For math help, go to the Math Appendix.

---

**Weather Disasters**

The United States sustained 67 weather-related disasters between 1980 and 2005, in which overall damages and costs reached or exceeded $1 billion at the time of each event, according to the National Climactic Data Center. How can businesses and people prepare for such disasters?

Go to the Introduction to Business Online Learning Center through glencoe.com to check your answers.
Handling Risk

Think about what you do to handle the risk you face in your day-to-day life.

Read to Learn
• Describe four ways that individuals and businesses can handle risk.
• List types of insurance protection.

The Main Idea
Risk of loss can be avoided, reduced, retained, or transferred. Insurance is a way to transfer the risk of loss to an insurance company, which agrees to cover you economically if certain types of risk result in a loss.

Key Concepts
• Handling Risk
• Insurance Protection

Vocabulary
Key Terms
premium hazard
peril insurance policy

Academic Vocabulary
You will find these words in your reading and on your tests. Make sure you know their meanings.
retain undergo
mode conversely

Graphic Organizer
In a figure like the one below, list and describe four ways individuals and businesses can handle risk.

Ways Businesses Handle Risk

Go to the Introduction to Business Online Learning Center through glencoe.com for a printable graphic organizer.

Academic Standards
English Language Arts
NCTE 1 Read texts to acquire new information
NCTE 3 Apply strategies to interpret texts
NCTE 12 Use language to accomplish individual purposes

Science
Content Standard G Students should develop understanding of historical perspectives in science
Handling Risk

Since you cannot completely avoid all risk, you must learn to handle it. There are four ways to handle risk. You can avoid, reduce, retain, or transfer risk. Most people and businesses use a combination of all these methods.

Risk Avoidance

Avoiding risk involves thinking about the consequences of decisions. For example, you could avoid the risk of a train accident by never riding a train. However, this would eliminate a mode of transportation that is considered very safe. In many cases you can avoid risk, but sometimes it is not practical to do so. For a business, risk avoidance means refusing to engage in a particularly hazardous activity. For instance, market research can lead a business to conclude that investment in a product or service is not worth the risk. All business decisions should be made with consideration of the potential for benefit and for risk.

BusinessWeek Reader and Case Study

Winning the Game of Risk

Some pros say investors aren’t paying enough attention to risk. Here are some smart steps to help protect your investments.

This may sound amazingly self-evident, but it’s worth repeating: Investing is inherently risky. And too much risk may be hazardous to your financial health. Anyone who has ever watched a stock like Google® or General Motors execute a power-dive knows how much sudden downturns can hurt a portfolio.

But unless you wish to stash your assets in the Bank of Posturepedic, you will have to take on some risk as you put your money to work. The trick is to take on the right amount for your age and your financial circumstances.

It’s not always easy, especially when financial market upswings can make investors complacent. Market veterans have increasingly warned against excessive risk. Most recently, bond-fund guru Bill Gross cited a possible downside in indexes he deems overvalued. “The crash of risk assets and their return to normalcy may be hard to time, but...these periods never end well,” the PIMCO chief investment officer wrote in his latest monthly outlook.

How much risk is too much? “It’s difficult to define,” says Phil Edwards, managing director of Standard & Poor’s Investor Services.

Case Study Go to the Introduction to Business Online Learning Center through glencoe.com for the BusinessWeek Reader Case Study.

Active Learning

Think about the risk you face every day—and the steps you take to minimize risk. Develop a poster about planning for a risk you think is controllable. Include five or more steps you take to control the risk.
Some risk cannot be avoided entirely. Instead you may need to practice risk reduction. For instance, your home should have smoke alarms and fire extinguishers. They can reduce the risk that a fire will cause damage. When you use equipment or tools, follow safety rules, wear protective glasses, and work in a properly designed work area to reduce the risk that you will be hurt.

Businesses practice risk reduction, too. For example, retail stores place electronic tags on expensive merchandise to discourage theft. This may not eliminate shoplifting, but it can reduce it. Business owners reduce risk by designing work areas to lower the chances of accidents or fire. They educate their employees about the safe use of equipment and keep safety equipment ready for use. Businesses also provide information about the correct use of products and warn customers about possible hazards.

**Screening and Training Employees** For most businesses, the best way to reduce risk from employee carelessness and incompetence is through effective employee screening, orientation, and training. Businesses screen applicants’ backgrounds and check references. Some companies now require prospective employees to undergo drug testing before being hired. Drug abuse can increase human risk by making employees careless and more likely to ignore or forget safety rules.
Risk Retention

It may be impossible to avoid certain types of risk. Bearing financial responsibility for the consequences of loss is called risk retention. For instance, suppose that your watch is valuable, but you enjoy wearing it anyway. If you take your chances on losing or damaging it, you will have to pay to replace it if necessary. You have chosen to retain the risk of the economic loss that you will lose or damage the watch.

A business may retain the risk that customer tastes will change and merchandise will not sell. They can underestimate the risk and stock too much merchandise. If consumer demand for that merchandise changes, they may have a greater loss than planned.

Definition: What is risk retention?

Risk Transfer

Insurance provides a way to transfer a risk of loss to an insurance company. Insurance divides a possible loss among large numbers of people or companies. Economic risk is shared most effectively when many people or businesses are involved. Each individual or company then pays a fee for protection.

Insurance Protection

Insurance protection requires careful planning and decision making. Choosing the right insurance plan is an important step. Insurance companies provide almost any kind of insurance you might want. How do you make your insurance choices? You must look at your individual situation and then choose the protection that fits your needs.

With insurance protection, no one person or business has to bear a loss alone. A premium is the price an insured person or business pays for insurance protection for a specified period of time. Insurance works on the “principle of large numbers,” which means many share a loss so that no one person or business carries all the risk.

Risk, peril, and hazard are important terms in insurance. In everyday life, these terms have almost the same meanings. In the insurance business, however, each word has a distinct and special meaning. While risk is the chance of loss or injury, peril is anything that may possibly cause a loss. It is the reason someone takes out insurance. People buy insurance against a wide range of perils, including fire, windstorms, explosions, robbery, and accidents. Hazard is anything that increases the likelihood of loss through peril. For example, defective electrical wiring in a house is a hazard that increases the chance that a fire will start.

Preventing Theft

Theft by employees and customers is one of the largest and most costly forms of human risk. Shoplifting is the act of stealing merchandise from a business. It is estimated that one-third of lost inventory is caused by shoplifting. Businesses often educate store employees about how to prevent it. They use adequate lighting and mirrors, and store expensive items in locked display cases to prevent theft. What are some other ways that businesses can prevent theft?
Individuals and businesses can insure property and people against potential loss by purchasing insurance policies. An insurance policy is a contract between a person and an insurance company to cover a specific risk. In return for the premium, or price for insurance coverage, the insurance company agrees to protect the policyholder against financial loss in case of an accident or loss that is covered in the policy.

Types of Insurance

There are several types of insurance for consumers. Life insurance offers protection for family members after someone dies. Property insurance covers damages or losses to your property. Conversely, liability insurance covers damages that you may have caused accidentally to someone else or to someone’s property. Health insurance provides money to pay medical bills in case of accident or sickness.

Many businesses offer life and health insurance coverage to their employees. They also carry liability and property insurance to protect their property. Companies carry workers’ compensation insurance to protect workers who are injured on the job. Workers’ compensation insurance is required by the government and paid for by employees. It provides medical and income benefits to employees injured on the job. Job-related illnesses, such as carpal tunnel syndrome, are also covered.

Section 33.2

Review Key Concepts

1. What are four ways to handle risk?
2. What is the difference between risk retention and risk transfer?
3. Identify some types of insurance.

Academic Skills

4. English Language Arts Look at the terms below. Cross out the one that does not belong with the others. Circle the term that could be used as the heading in a list with the others.
liability property damage
bodily injury safety

5. English Language Arts Write a letter to your state’s commissioner of insurance asking for information on the minimum automobile insurance requirements for your state. Write a paragraph about the response you receive.

Go to the Introduction to Business Online Learning Center through glencoe.com to check your answers.
Section 33.1 Summary

**Types of Risk** Every person and business risks loss. Risk may be controllable or uncontrollable and insurable or uninsurable. Economic risk includes personal risk, property risk, and liability risk. Human risk caused by human mistakes or dishonesty is a particular problem for businesses. Natural risk caused by the weather can result in financial loss and damage.

Section 33.2 Summary

**Handling Risk** Risk can be avoided, reduced, retained, or transferred. Individuals and businesses try to avoid and reduce risk whenever they can, but some risk is inevitable. Both businesses and people can transfer risk. Insurance provides a way to transfer risk to an insurance company. Insurance enables a large number of people to share a possible loss.

Vocabulary Review

1. On a sheet of paper, use each of these key terms and academic vocabulary terms in a sentence.

<table>
<thead>
<tr>
<th>Key Terms</th>
<th>Academic Vocabulary</th>
</tr>
</thead>
<tbody>
<tr>
<td>risk</td>
<td>economic risk</td>
</tr>
<tr>
<td>risk management</td>
<td>human risk</td>
</tr>
<tr>
<td>insurable risk</td>
<td>natural risk</td>
</tr>
<tr>
<td>insurance</td>
<td>premium</td>
</tr>
<tr>
<td>uninsurable risk</td>
<td>peril</td>
</tr>
<tr>
<td>controllable risk</td>
<td>hazard</td>
</tr>
<tr>
<td>uncontrollable risk</td>
<td>insurance policy</td>
</tr>
<tr>
<td>pure risk</td>
<td>criteria</td>
</tr>
<tr>
<td></td>
<td>retain</td>
</tr>
<tr>
<td></td>
<td>minimize</td>
</tr>
<tr>
<td></td>
<td>mode</td>
</tr>
<tr>
<td></td>
<td>decade</td>
</tr>
<tr>
<td></td>
<td>undergo</td>
</tr>
<tr>
<td></td>
<td>occurrences</td>
</tr>
<tr>
<td></td>
<td>conversely</td>
</tr>
</tbody>
</table>

Review Key Concepts

2. Discuss risk and risk management.
3. Describe different types of risk.
4. Describe four ways that individuals and businesses can handle risk.
5. List types of insurance protection.
Critical Thinking

6. Some people would rather take their chances than to try to avoid risk. Do you think this is a good or bad approach to risk?

7. What types of anti-shoplifting measures have you observed in stores?

8. Tornadoes, hurricanes, and floods have caused devastating losses in recent years. What do you think can be done to reduce losses from disasters?

9. Explain the difference between “economic risk” and “economic loss.”

10. Some people do not take precautions to avoid risk because they think that their insurance company will reimburse them for any losses that they incur. What do you think?

11. How can businesses take precautions against customer dishonesty without offending their honest customers?

12. What advice would you give business owners to make their computer systems safer?

13. What problems can insurance companies face because of natural disasters?

14. Research uninsurable risk. What types of risk are uninsurable? Why? Is there a way to avoid an uninsurable risk? In at least one page, discuss your answer.

15. In at least two paragraphs, discuss some of the safety measures that your school has in place to reduce the risk of loss or injury.

16. Many employees take company property for their personal use. Write a brief e-mail to your teacher about the impact this can have on a business.

17. One way to reduce risk is to increase safety. List guidelines for people to reduce their risk of property loss, injury, or death on the road.

18. Choose a business in your community. Research the risk that this type of business might encounter. Write at least two paragraphs on your findings.

19. An insurance agent helps people to identify the purposes of their insurance plan and develops a program for them. Research the job of insurance agent. Write a report on the qualities that a good insurance agent should have.

Technology Applications

Spreadsheet Software

20. Injuries and illnesses in the workplace can result in lost wages, increased medical expenses, and higher workers’ compensation payments. Research the number of injuries and illnesses and their sources among U.S. workers. Prepare a spreadsheet and chart summarizing the information you obtain. Use the Internet or reference books in your library to find information.

Business Ethics

Should She Return the Check?

21. Imagine that someone broke into your friend Teresa’s home and stole her jewelry box. Teresa files a police report as well as an insurance claim for the stolen items. In both reports, she lists several pieces of jewelry as stolen, including a diamond necklace insured for $1,000. In a few days, the insurance company issues her a check for $1,000. The following week, she finds the necklace hidden in a closet. What should she do?
Chapter 33 Review and Activities

Applying Academics to Business

English Language Arts
22. Work with a group of three or four students to research the different types of vehicle insurance coverage. Create an outline for a short presentation, and give it to the class.

Mathematics
23. You recently purchased a used car for $5,000 with help from a bank that loaned you the money with a 6% simple interest loan. If your insurance costs you $230 quarterly, how much will the insurance and interest cost you in the first year?

Comparing Rates
In a problem such as this, you will need to choose whether to compare the cost on a monthly, quarterly, or yearly basis.

Active Learning

Attitudes About Risk
26. People have different ways of handling risk. Work in teams. Survey at least 10 people in your neighborhood or school about their attitudes toward risk. Which risk do they run each day at home, at school, or at work? What are some ways they avoid or reduce each risk? Compile your findings, and share the results with the class.

Business in the Real World

Sick-Leave Policies
27. Time off from work because of employee illnesses is a huge cost to businesses. Many companies have wellness policies in place to promote good health. Interview a local business owner about his or her sick-leave policy. Ask about the number of sick days each employee is granted. Does the business also offer exercise and fitness programs? Write a report of your findings, and share it with the class.
Dealing with Uncontrollable Risk

28. Suppose you have a retail store that sells imported furniture. Your main supplier is in a country that is undergoing major economic and political changes. These changes are being closely watched by your federal government, which may adjust its trade policies with the country. In one page or more, discuss the types of risk you might encounter and how to address them.

Reducing Risk from Hazards in the School

30. Situation You have been asked to present a plan for reducing risk at your school. With three of your classmates, prepare a list of risks and ways to reduce or eliminate them.

Activity As a group, create a presentation for your school administrators on risk: Include your suggestions for reducing or eliminating risks.

Evaluation You will be evaluated on how well you meet the following performance indicators:

- Describe the process your group followed to identify risk in school.
- List the causes of various risks.
- Suggest ways to reduce or eliminate each risk.
- Prepare a written report using presentation software.

Standardized Test Practice

Directions Choose the letter of the best answer. Write the letter for the answer on a separate piece of paper.

1. Which best completes the sentence?
   ___________ insurance covers damage done to another person’s vehicle or property.
   A Collision
   B Property damage liability
   C Bodily injury liability
   D Miscellaneous coverage

Test-Taking Tip When studying for a test, write important ideas, definitions, and formulas on flash cards. Make a tape of your notes. Use these tools to review and prepare for test day.

Reading Go to the Introduction to Business Online Learning Center through glencoe.com for a list of outside reading suggestions.